

The **GSE** REPORT TM

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 - "Since so much of mortgage lending is affected directly or indirectly" by Fannie and Freddie's automated underwriting [AU] systems, HUD's release of its fair lending review of Fannie and Freddie's AU systems is "long overdue" and "fair housing and affordable housing groups should press for this information to be released."
 - HUD expects to release its fair-lending review of Fannie & Freddie's AU systems by year-end - HUD has been investigating Fannie & Freddie's AU system for fair lending violations since 1999
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Major Events

House passes bill which repeals a 50% increase in the Ginnie Mae guarantee fee

Bill is ready to be signed by the President

Mortgage Bankers Association supports repealing the Ginnie Mae guarantee fee increase

- The House passed a bill (S. 2239 – FHA Downpayment Simplification Act) November 15 that would among things, repeal a scheduled increase in the guarantee fee charged by Ginnie Mae for guarantee of mortgage-backed securities from 6 to 9 basis points. The increase would have gone into effect in FY 2004 (October 1, 2003). “This is truly a victory for low-to moderate-income families in America in need of affordable housing, and it’s a win for the US economy,” said Kurt Pfothenhauer, MBA’s Senior Vice President of Government Affairs. “We commend Congress for its action.” (*MBA press release*, 11/15/02; *CQ Daily Monitor*, 10/18/02) The MBA supported the provision repealing the Ginnie Mae guarantee fee increase. (*MBA press release*, 6/18/02) The MBA estimated the increase would have cost \$30 million or more a year and would have penalized families in need of government programs to buy a home. In addition, the MBA noted there was no financial basis for a guarantee fee increase because Ginnie Mae is currently operating at a profit. (*MBA press release*, 3/18/02)
- The Senate passed S. 2239 by voice vote October 17. The bill will now go to the President for his signature. (*National Mortgage News Daily website*, 11/15/02)

The shift in control of US Senate to Republicans may make life more difficult for Fannie & Freddie, reports Bloomberg

Support for “Ginnie Mae Choice” legislation may increase

“Ginnie Mae Choice” supporters say the proposal will lower costs to consumers, increase revenue to the federal government, and create competition for Fannie & Freddie

- The shift in control of the US Senate to Republicans following the November congressional elections may make life more difficult for Fannie & Freddie, reported Al Yoon with *Bloomberg News*. When Congress convenes in January, the Republicans will take control of both the House Financial Services Committee and the Senate Banking Committee, which may increase support for legislation that would increase competition for Fannie and Freddie by opening their market to Ginnie Mae. Legislation to permit Ginnie Mae to securitize privately insured mortgage loans for the first time and allow Ginnie Mae to compete with Fannie and Freddie – referred to as “Ginnie Mae Choice” - may draw more support in the Senate now that Senator Wayne Allard (R-CO) is in line to chair the Senate Banking Committee’s Housing Subcommittee. Senator Allard and Congresswoman Marge Roukema (R-NJ) introduced Ginnie Mae Choice legislation last year. (*Bloomberg News*, Al Yoon, 11/7/02) [See November 9, 2001 and December 7, 2001 *GSE Reports* for more information on “Ginnie Mae Choice” legislation, www.gsereport.com.]
- Paul Muolo with *National Mortgage News*, however, believes that GSE critics will be “disappointed” if they think Republican control of Congress will increase the chance for passage of legislation or changes to curb GSE growth. He believes President Bush will continue to support homeownership initiatives and will need the assistance of Fannie and Freddie. He also noted that GSE critics lost one of their “biggest supporters in Senator Phil Gramm (R-TX),” who is retiring in January to take a position with UBS Warburg, an investment banking firm that makes a significant amount of money from Fannie and Freddie. (*National Mortgage News*, Paul Muolo, 11/11/02) Muolo observed that because incoming Senate Banking Committee

Chairman Richard Shelby (R-AL) is considered a populist, it is expected that he will support Fannie and Freddie. Muolo also noted that one of Senator Shelby's largest contributors is Fannie which gave more than \$17,000 in the 2002 election cycle (as of early September). (*National Mortgage News Weekend edition*, 11/9-10/02)

Incoming Senate Banking Committee Chairman Richard Shelby (R-AL) says Fannie & Freddie should stick with their core mission

- In a November 14 interview with *Reuters*, Senator Shelby said Fannie and Freddie played an important role in promoting homeownership, but should stick to their core mission. Senator Shelby said Congress must monitor Fannie and Freddie but treat them fairly. "I think you have to start with the fact that the GSEs have really helped bring about widespread homeownership for this country. There has been a social as well [as] economic benefit here." He noted, however, that the "GSEs are huge today. I think they should stay with their core mission." He further added, "And we should see what they are doing well, and do we need to change anything? I think we should be objective about it, be fair." [When Congress convenes in January, Senator Shelby is expected to become the new Senate Banking Committee Chairman.] (*Reuters*, 11/14/02)

Capital Markets Subcommittee Chairman Richard Baker (R-LA) plans to examine the regulation of Fannie & Freddie next session

- Congressman Baker plans to examine the regulation of Fannie and Freddie, probably starting with their accounting methods. He said the debate on the GSEs "may be a floor" on which broader debate over the regulation of banks and insurance companies might be held. (*American Banker*, Michele Heller, 11/14/02)

Incoming House Financial Services Committee Ranking Democrat Barney Frank (D-MA) defends Fannie & Freddie, but says he would like Fannie & Freddie to do more for low-income housing

- In a November 13 press conference, Congressman Frank defended Fannie and Freddie. "I don't think Fannie Mae and Freddie Mac are the problems here," he said. "Some people had tried to get Fannie and Freddie to pull back, saying they pose too great a risk to taxpayers. I don't think that's accurate...I would be very reluctant to change anything." However, Congressman Frank said he would like to see Fannie and Freddie do more for low-income housing and generally said he plans to pursue legislation and funding for affordable housing programs. (*Dow Jones Newswire*, Dawn Kopecki, 11/13/02) [When Congress convenes in January, Congressman Frank is expected to become the new Ranking Democrat on the House Financial Services Committee.]
- As noted in the September 27, 2002 *GSE Report*, Congressman Frank said he would consider proposals to remove Fannie and Freddie's line of credit to the Treasury and their special tax exemptions, but then appeared to back off statements, after calls from Fannie and Freddie. [See September 27, 2002 *GSE Report* for more information, www.gsereport.com]

American Bankers Association (ABA) forms partnership with FHLBanks' Mortgage Partnership Finance program (MPF)

Partnership expected to level the playing field for community banks and increase competition to Fannie & Freddie in the secondary mortgage market

- The ABA and the FHLBanks' MPF Program announced November 18 a new strategic alliance to develop a program that will benefit community mortgage lenders and increase competition in the secondary mortgage market. Under the expected arrangement through ABA's subsidiary, the Corporation for American Banking, high-quality mortgages originated by smaller community lenders will have improved access to the MPF Program. Because this will result in larger volume and wider geographic representation, participating banks will receive additional fee income and added value – at no cost – for their MPF mortgages. All FHLB member financial institutions will be eligible to participate. The ABA-MPF program is expected to be available in the first quarter of 2003. (*FHLBank of Chicago's MPF press release, 11/18/02*)
- “This alliance is an ideal fit for the ABA and our member banks,” said Donald G. Ogilvie, ABA president and CEO. “Our mission is to enhance the profitability of our members, and this new program does just that – it gives banks an alternative that allows them to compete more effectively in the mortgage markets,” said Ogilvie. (*FHLBank of Chicago's MPF press release, 11/18/02*)
- “We are pleased and excited to partner with the ABA in a way that will allow smaller FHLB members to participate in the secondary mortgage market as equals,” said Alex J. Pollock, president and CEO of the FHLBank of Chicago, which created the MPF Program. (*FHLBank of Chicago's MPF press release, 11/18/02*)
- The MPF Program began in 1997 as a strategic alternative for mortgage lenders originating fixed-rate conventional and government loans. The MPF Program offers FHLBank System members an alternative to selling their loans to Fannie and Freddie in the secondary mortgage market. The MPF's unique risk-sharing structure allocates mortgage risks to the party best suited to handle them. Local banks are paid to manage the credit risk of their loans, while also maintaining their valuable customer relationships. The FHLBanks manage the interest rate risk and prepayment risks of the loans. MPF lenders benefit both from more profitable mortgage operations and from the increased dividends they receive from the FHLBs. Homebuyers benefit from the increased efficiency and competition provided by the program. To date, over 400,000 American households in all 50 states and the District of Columbia have received more than \$50 billion of MPF financing. Over 400 FHLBank members in 35 states are approved to participate in the MPF Program through nine FHLBs. The ABA-MPF Alliance is expected to further increase the rapidly growing participation in the MPF Program, particularly among community banks. More than 70% of current participating members are community financial institutions having assets of less than \$500 million. (*FHLBank of Chicago's MPF press release, 11/18/02*)

America's Community Bankers (ACB) supports the FHLBanks' mortgage purchase programs (e.g., MPF program) and potential securitization of the mortgage purchase program loans

ACB remains concerned about Fannie & Freddie's \$1,000 investment notes (debt) to consumers

Treasury Department raised concerns in June with the SEC about the marketing of Fannie & Freddie's investment notes

- Addressing a recent ACB convention, the outgoing Chairman of the ACB Curtis Hage said that while ACB supports their "affinity" relationships with Fannie and Freddie, the ACB remains a strong advocate of the FHLBank System's Mortgage Partnership Finance (MPF) Program and Mortgage Purchase Programs (MPP) and said community leaders like the idea that MPF and MPP loans might, one day, be securitized. The ACB held a panel discussion at the convention to discuss the possibility of the FHLBanks securitizing MPF and MPP loans. (*National Mortgage News*, Scott Kersnar, 11/11/02) [The MPF and MPP Programs offer FHLBank System members an alternative to selling their loans to Fannie and Freddie in the secondary mortgage market.]
- The new Chairman of the ACB, D. Russell Taylor, said that ACB remains concerned about Fannie and Freddie's \$1,000 investment notes to consumers, which they feel compete with federally insured certificates of deposit. Taylor claimed the notes are primary market instruments that are advertised directly to consumers. The GSEs "have a secondary market charter and they should not be entering the primary market for branding purposes," he stated. (*National Mortgage News*, 11/4/02) Fannie's investment note program (launched in May 2001) is called "Investment Notes" and Freddie's program (launched in April 2001) is called "FreddieNOTES. Freddie raised \$9.5 billion through sales of its FreddieNOTES since last April, while Fannie sold \$5.3 billion of its investment notes since last May. (*Dow Jones Newswire*, Dawn Kopecki, 5/9/02)

Treasury Department raised concerns with the SEC about the marketing of Fannie & Freddie's investment notes

- As noted in the June 14, 2002 *GSE Report*, in a **June 4 letter to the SEC, then Treasury Assistant Secretary for Financial Institutions Sheila Bair warned that investors "may not fully understand the risks" associated with GSE securities and may not understand that GSE securities are not government guaranteed. Bair also raised concerns about the marketing of Fannie and Freddie's \$1,000 investment notes to consumers and warned about the marketing of mutual funds containing GSE securities. Bair noted that many mutual funds market themselves as being comprised primarily of securities that are backed by the full faith and credit of the US government, when they have a large proportion of GSE securities (that are not government-guaranteed).** (*Treasury Assistant Secretary Bair's letter to SEC*, 6/4/02)
- Bair raised concerns about the marketing of Fannie and Freddie's \$1,000 investment notes to consumers. Bair noted that these retail investment securities are not sold directly by Fannie and Freddie, but through securities broker-dealers. She noted, "Some broker-dealer marketing efforts rely heavily on the GSEs' relationship to the government as a selling tool. While the GSEs are required to and do clearly disclose that the Federal government does not guarantee their securities, little or no mention of the lack of a Federal guarantee is typically included in broker-dealers' marketing efforts." (*Treasury Assistant Secretary Bair's letter to SEC*, 6/4/02; *Reuters*, Mark Felsenthal, 6/5/02)
- Bair noted that sales literature circulated by some brokerage firms seem to "skimp on the warning label" that the GSEs are not government guaranteed. Bair cited as an example a sales piece by Edward D. Jones, a regional brokerage firm that was offering Freddie's bonds in denominations sized for retail investors. The

brochure noted that the issuer was “created by Congress” but never stated that its debts are not guaranteed by the government. Freddie’s spokeswoman Sharon McHale said the company had already asked Edward D. Jones to discontinue the brochure. (*New York Times*, Alison Leigh Cowan, 6/6/02) [See June 14, 2002 *GSE Report* for more information about Treasury’s letter raising concerns about the GSEs’ investment notes.]

Treasury letter prompted by ACB letter raising concerns about Fannie & Freddie’s \$1,000 investment notes

- *Dow Jones Newswires’ Dawn Kopecki* reported that Treasury’s letter was prompted by a March 8 letter by the ACB which asked the Treasury Department to prohibit Fannie and Freddie from targeting their core customers, complaining that Fannie and Freddie’s investment notes were being marketed as a safe alternative to bank certificates of deposit, which are backed by the FDIC. **The ACB told the Treasury Department that Fannie and Freddie’s small denomination debt instruments “are inconsistent with the purposes for which these government-sponsored secondary market enterprises (GSEs) were created.”** The ACB said these investment notes appear to “be intended to establish the Freddie Mac and Fannie Mae brand names as retail brand names that would facilitate their entry into other retail markets, including that of deposit-like instruments and home mortgage loan originations.” (*Dow Jones Newswire*, Dawn Kopecki, 5/9/02, 6/5/02; *ACB’s Diane Casey letter to Treasury Secretary Paul O’Neill*, 3/8/02)
- Banks are concerned that these investment note programs could harm banks’ ability to attract depositors and “threaten the deposit base of insured depository institutions across the country.” Small banks simply don’t have the resources to develop comparable products, the group said, and they can’t really compete against Fannie and Freddie. Bankers are also concerned about Fannie and Freddie’s aggressive marketing tactics under their investment note programs. Both GSEs shifted their marketing strategies to target retail investors about a year ago and critics said that retail focus misuses their government subsidy and oversteps their congressional charter by providing a product already offered by the private marketplace. The ACB charged that “dealers are marketing these instruments to relatively unsophisticated consumers, and possibly representing the securities as fully ‘guaranteed’ by the US government.” (*Dow Jones Newswire*, Dawn Kopecki, 5/9/02, 6/5/02; *ACB’s Diane Casey letter to Treasury Secretary Paul O’Neill*, 3/8/02)

American Enterprise Institute (AEI) Resident Fellow Peter Wallison says the FHLBank System is preferable to Fannie & Freddie

Compared to Fannie & Freddie, the FHLBanks pass more of their subsidies to borrowers, present less of a mission creep threat, are better capitalized (less risk to taxpayers), and have a better affordable housing record

Although the FHLBank System’s cooperative structure is preferable to Fannie & Freddie’s corporate structure, Wallison believes it is time for the FHLBanks and Fannie and Freddie to be privatized

- In a November 14 speech to the 2002 FHLBank Directors Conference, AEI’s Peter Wallison compared the FHLBank System with Fannie and Freddie. Although they are all housing GSEs, a key distinction is that the FHLBank System is organized as a cooperative, and Fannie and Freddie are organized like private companies. Although Wallison is “no fan of GSEs – either the cooperative kind like the Federal Home Loan Banks or the profit-maximizing kind like Fannie and Freddie,” he sees a real distinction between the FHLBank System and Fannie and Freddie.

FHLBanks pass more of their GSE subsidies to borrowers

- Wallison stated, “Because of the structure of the FHLBank system, it is reasonable to believe that the subsidy the Banks derive from their association with the government actually gets passed through to

borrowers. This is because there is real competition among the members of the Federal Home Loan Bank system, and this likely forces them to pass their subsidy along to their customers. And since it is difficult to trace what this lower cost funding is actually used for, it is also reasonable to believe that the subsidy received by the Federal Home Loan Banks is spread throughout the economy at large and not confined to a special privileged group.”

- In contrast, “The same is not true for Fannie and Freddie. The fact that they are able to produce consistent returns on equity in the range of 25 percent is, I think, good evidence that they are not competing with one another. Indeed, government studies have shown that of the subsidy Fannie and Freddie receive approximately one-third is retained for the benefit of their managements and shareholders. In other words, while the subsidy realized by the Federal Home Loan Banks turns out to be a subsidy to public at large, the subsidy realized by Fannie and Freddie is the worst kind of corporate welfare—a transfer of wealth from the taxpayers to both the generally well off (Fannie and Freddie’s investors) and the genuinely wealthy (Fannie and Freddie’s managements).”
- “Thus, while I don’t think that we need housing GSEs at all, I don’t see any particular harm in the FHLBanks continuing their functions.”

FHLBanks present less of a mission creep risk

- Wallison stated, “There are other dimensions in which Fannie and Freddie present risks to the financial system that are not presented by the FHLBanks. Mission creep is certainly one of these, and in my view the most serious problem we face from these two entities. Because of their form as profit-making shareholder-owned companies, they combine the aggressiveness of private sector corporations—something we clearly value—with the monopoly power of government—something we do not. Unless they are reined in by tough regulations from their mission regulator—the Department of Housing and Urban Development—they will be able to extend their activities to areas of the economy outside the secondary mortgage markets. They are already doing this to some extent—getting into aspects of consumer finance and commercial lending--without a peep from HUD. There is also the possibility that the FHLBanks may extend their activities to small business lending—under new authorities they received in the Gramm-Leach-Bliley Act—but since they are cooperative entities they do not have the incentives to develop this activity aggressively in the way that is so clear in the case of Fannie and Freddie.”

FHLBanks are more capitalized

- Wallison noted, “the FHLBanks are better capitalized than Fannie and Freddie, and so do not present the risk to taxpayers that Fannie and Freddie present. And since the FHLBanks are not the only source of credit for their members—just a less expensive source—if they were to have difficulty raising funds they would not have the systemic effects on the economy as a whole that would come from a similar difficulty for Fannie and Freddie.”

FHLBanks have a better affordable housing record

- Fannie and Freddie’s directors “are expected to serve the interests of the corporation and the shareholders by seeing to the maximization of profits. The fact that they have a government mission is irrelevant... Study after study has shown that they [Fannie and Freddie] are doing less for those who are underserved in the housing market than banks and thrifts. Not only do they buy fewer mortgages than are originated in minority communities, the ones they buy tend to be seasoned and thus less risky. Despite Fannie’s claims about trillion dollar commitments, they are meeting their affordable and minority housing obligations by slipping through loopholes in the loosely written and enforced HUD regulations in this area. In other words, two companies that are immensely profitable and claim to have a government mission, are doing as little as they can get away with for those who most need assistance—while swamping the airwaves with advertising that they are putting people in homes. This should be no surprise, since their incentives push them in this

direction. As shareholder-owned companies, they are maximizing their profits...while doing just enough to avoid the criticism that might result in the loss of the government support that enables them to earn these profits. In 1996, the Congressional Budget Office estimated that 42 percent of the profits that Fannie and Freddie reported in 1995 were derived directly or indirectly from their government backing.”

- Wallison added, “In part, I blame HUD for letting Fannie and Freddie get away with this. Over both Republican and Democratic administrations, HUD has failed to adopt regulations that would require Fannie Mae and Freddie Mac to use a significant portion of the profits they derive from their government support to add appreciably to the housing finance resources available to low-income families. This is in part because the HUD regulations establish a single broad category for low and moderate income families—allowing Fannie and Freddie to meet their requirements through the purchase primarily of moderate income mortgages—and also define underserved areas so broadly that Fannie and Freddie are not compelled to purchase many of the mortgages that banks and thrifts make in meeting their CRA obligations. In a memorable demonstration at an AEI conference two years ago, Jonathan Brown of Essential Information showed aerial views of Chicago neighborhoods with overlays for areas where Fannie and Freddie were and were not purchasing mortgages. Brown’s overlays showed clearly that the low income and minority areas of Chicago were being bypassed by Fannie Mae and Freddie Mac. Why does HUD allow this to happen? The only answer can be the lack of political will—the inability or unwillingness of administration after administration to confront the extensive political network that Fannie Mae and Freddie Mac have assembled in Washington.”
- “Fortunately, the Federal Home Loan Banks have nothing to apologize for in this respect...each of the 12 FHLBanks contributes 10 percent of its earnings each year to support either the purchase, construction or rehabilitation of very low, low and moderate income housing. A portion of these funds may also be used for community development, and individual banks can—and have—established their own programs for downpayment assistance for low income families. In 2001, FLHB contributions for the Affordable Housing Program were \$239 million. As cooperative enterprises, these contributions are in effect reductions in the benefits the members of the Banks receive from their membership.”

Although the FHLBank System’s cooperative structure is preferable to Fannie & Freddie’s corporate structure, Wallison believes it is time for the FHLBanks and Fannie and Freddie to be privatized

- Wallison is “no fan of GSEs – either the cooperative kind like the Federal Home Loan Banks or the profit-maximizing kind like Fannie and Freddie.” However, the organization of the FHLBank System is preferable to Fannie and Freddie. Wallison noted, “I don’t think government has any business sponsoring an enterprise unless there is a demonstrated market failure.” Fannie and Freddie and the FHLBank were established to address a market failure – the inability of mortgage originators such as thrifts and banks to obtain sufficient asset liquidity. But now, there is no market failure and there are many fully private sources of liquidity for residential mortgages. “It’s time, in my view, for GSEs that are engaged in residential finance to close up shop or to privatize in a real sense – that is, to cut their links with the government and compete on a level playing field with everybody else.”
- Wallison’s view of the GSEs is “that the form in which Fannie Mae and Freddie Mac have been chartered—as shareholder-owned profit making companies—should never be used for a government sponsored enterprise. Government sponsorship implies a government mission, and as I suggested before there is an inherent conflict between the responsibilities of the directors and management of a shareholder-owned profit-making enterprise and the performance of a government mission. This conclusion comes into sharper focus when the efforts of Fannie Mae and Freddie Mac to evade their public responsibilities for assisting low income housing are compared to the views of directors and managers of FHLBanks about their mission. In the former case, the government connection has become an asset to be exploited, and the mission a

secondary consideration; in the latter case, the government connection has induced serious thought about what the mission is and how it can be performed.”

- Wallison concluded, “Although I still have doubts about the need for any government assistance to the financial economy, I have no doubt about how—if Congress decides to use a government sponsored enterprise—such an enterprise should be organized. The cooperative form, and not the business corporation form, makes room for and encourages a GSE to discharge its public trust.” (*AEI Resident Fellow Peter Wallison speech before the 2002 FHLBank Directors Conference, 11/14/02*)

Wall Street Journal commentary says Fannie would continue to prosper and taxpayers would breathe easier if Fannie was privatized

Fannie willingly exposes itself to interest-rate risk by holding a huge portfolio of mortgages, which has nothing to do with Fannie’s chartered mission and only increases the GSEs’ profits

Fannie’s mission is to provide liquidity to the secondary mortgage market – a need which “is long gone”

Fannie claims its new mission is to reduce mortgage interest rates but the beneficiaries of Fannie’s rate reductions are “mostly middle- and high-income households”

- A November 13 *Wall Street Journal* commentary by Susan Lee (a *Wall Street Journal* editorial board member) says Fannie “willingly (and happily) exposes itself to interest rate risk.” Lee noted “there is nothing in its government charter that even remotely requires Fannie to borrow great gobs of money to purchase and hold a huge portfolio of mortgages. Fannie does it because it is wildly profitable. Because of the implied government guarantee of its debt, Fannie can borrow at very low rates and then lend out that money at higher rates by retaining or repurchasing the mortgages it has securitized. This opportunity to borrow low and lend high is so seductive for profits, it’s almost a form of entrapment.”
- In order to purchase and hold this huge portfolio of mortgages, Fannie has issued “an amazing amount of debt.” Currently Fannie’s outstanding debt is around \$800 billion and its debt relative to its small capital base gives it enormous leverage. Lee noted that Fannie’s required core capital is 2.4% of on-balance sheet assets and 0.45% of outstanding mortgage-backed securities and other off-balance sheet obligations – “well below levels necessary for FDIC-insured commercial banks; even government securities dealers carry capital around 5% of assets. Fannie is running with this huge leverage (about 54-to-1) because it can -- shareholders, at least until this year, didn’t seem to care.” Taxpayers are the “ultimate creditors” and are “stuck” with Fannie’s potential liability. At the end of the third quarter, Fannie’s combined debt and its mortgage-backed securities held by outside investors totaled \$1.8 trillion.
- Fannie’s mission is to provide liquidity to the secondary mortgage market – a need which “is long gone.” Therefore, “Fannie now says that its mission is to provide affordable housing by reducing mortgage interest rates.” However, studies show that the beneficiaries of Fannie’s mortgage interest rate reduction are “mostly middle- and high-income households. These are people who would own homes anyway, but are encouraged to buy larger and fancier homes or second homes.”
- Lee claimed Fannie would continue to prosper and taxpayers would breathe easier if Fannie was privatized. “The advantages of privatization should be enticing. Fan [Fannie] would free itself from current regulatory constraints like being limited to the residential mortgage business, restrictions on the maximum size of mortgages, and oversight by the evil twins, HUD and OFHEO. Once liberated from its ‘special relationship’ with the government, Fannie could expand into jumbo and subprime lending, and go into new businesses, like securitizing credit cards and auto loans. Fannie has a well-known brand name and fairly seethes with

experienced and skilled human capital. No doubt a free Fannie would continue to prosper. And taxpayers, having had a massive risk transferred to the private credit markets, would be free to breathe a little easier, too.” (*Wall Street Journal Commentary*, Susan Lee, 11/13/02)

Fannie’s duration gap narrows to negative six months

This is the first time since June that Fannie’s duration gap has fallen within its targeted range of plus or minus six months

While Fannie’s duration gap narrows, its counterparty risk increases

The duration gap - a measurement of Fannie’s interest rate risk – reflects a mismatch between Fannie’s assets and liabilities

Fannie’s holding of mortgages in its portfolio declines for a second time this year, raising concerns that Fannie will not meet its portfolio growth target for 2002

- Fannie reported November 15 that its duration gap narrowed to negative six months at the end of October from September’s negative 10 months, showing a further decrease of interest rate risk on its investment portfolio. (*Reuters*, 11/15/02) Fannie’s current duration gap of negative six months means that Fannie’s mortgage assets will be repaid and replaced at a lower interest rate six months sooner, on average, than its outstanding debt. This is the first time since June that Fannie’s duration gap has fallen within its targeted range of plus or minus six months. (*Bloomberg News*, Heather Bandur and Al Yoon, 11/15/02) In August, Fannie’s duration gap reached minus 14 months, its widest level ever reported publicly, though it has been larger on an intra-month basis. (*Reuters*, Aleksandrs Rozens and Richard Leong, 9/16/02; *Reuters*, Aleksandrs Rozens, 9/16/02) Fannie’s duration gap was negative nine months in July and negative four months in June. (*Reuters*, 10/1/02; *Bloomberg News*, Heather Bandur and Al Yoon, 11/15/02)

Background on Fannie’s duration gap

- Fannie’s duration gap, particularly its negative 14 month duration gap in August, has received a lot of attention and raised concerns about Fannie’s interest rate risk management of its portfolio. Fannie defended its 14 month duration gap in August and said the mismatch was not unusual during periods of heavy refinancing. In contrast to Fannie’s negative 14 month duration gap in August, Freddie announced that its duration gap was zero. OFHEO called Fannie’s negative 14 month duration gap a “substantial mismatch” and said it would increase its oversight to help Fannie balance its duration gap, including conducting weekly examinations of Fannie’s effectiveness in narrowing its duration gap. Capital Markets Subcommittee Chairman Richard Baker (R-LA) criticized OFHEO for not acting sooner and asked OFHEO for its weekly status reports on Fannie. Congressman Baker noted in his October 23 letter to OFHEO that OFHEO has been providing status reports orally, due to the confidential nature of such information. A *Wall Street Journal* editorial and a group of prominent scholars – the Shadow Financial Regulatory Committee – said taxpayers should be concerned about Fannie’s duration gap and recommended prohibiting Fannie and Freddie from purchasing their own mortgage-backed securities for their retained portfolios. Citizens Against Government Waste (CAGW) stated that Fannie’s duration gap should lead to calls for increased financial disclosures by Fannie & Freddie. [For more information on Fannie’s negative 14 month duration gap and the reaction by the market, see the September 27, 2002 *GSE Report*, www.gsereport.com] In an October 23 letter to OFHEO, Congressman Baker raised additional concerns about Fannie’s duration gap including: (1) questioning OFHEO about when it became aware of Fannie’s negative 14 month duration gap and how does it ensure that it is informed on a timely basis if Fannie and Freddie are facing a serious interest rate risk problem; (2) whether Fannie and Freddie have comparable duration gap disclosures; and (3) how Fannie rebalanced its duration gap and whether this rebalancing raised supervisory concerns. [See

Explanation of a duration gap

- The gap represents a mismatch in cash flows between Fannie's assets (mortgage bonds and loans it owns) and liabilities (debt it issues to buy these assets). The duration gap measures the difference, in months, between the durations of the assets and the liabilities in Fannie's portfolio. "In simplest terms," a duration gap is a "mismatch between borrowing and lending." Fannie purchases mortgages from lenders in the secondary mortgage market and in order to purchase the mortgages, it sells bonds (issues debt) to investors. Fannie makes money by collecting more interest on the mortgages it holds than it pays out on the bonds (debt) it sells. For example, Fannie does not want to buy a 30-year mortgage using money that it borrows by issuing 10-year bonds. "If it did that, when the bonds come due, there wouldn't be enough money to pay them off. The mismatch between the life of the mortgage and the life of the bond" is called a duration gap. (*Washington Post*, Jerry Knight, 9/23/02; *Philadelphia Inquirer*, Andrew Cassel, 9/25/02)
- As part of the GSEs' October 2000 voluntary risk-management agreement, Fannie and Freddie announced that they would provide monthly interest-rate disclosures. Fannie announced that it would disclose the two primary measures of interest rate risk it uses in managing its mortgage portfolio business: portfolio net interest income at risk and the effective asset/liability duration gap. Fannie first published its monthly interest rate risk disclosure in March 2001; Freddie in April 2001.

While Fannie's duration gap shrinks, its counterparty risk increases

- *Dow Jones Newswire's* Julie Haviv noted that Fannie's third quarter investment analyst report revealed some information on Fannie's derivatives counterparty exposure and how it narrowed its duration gap. Fannie's exposure to counterparty default increased to \$401 million at September 30, 2002, compared to \$278 million at June 3, 2002. One analyst said this increase is not "outrageous" given Fannie's overall use of derivatives. Fannie's credit exposure on derivative contracts was \$2.723 billion at September 30, 2002. "We continue to believe that Fannie Mae's chief risk here remains systemic risk given the increasing concentration of business in a few large bank counterparties," said a Goldman Sachs analyst report. Fannie said all of its exposure was to counterparties rated single-A-minus/A3 or higher. Fannie held \$2.322 billion of collateral through custodians for these instruments. As of March 31, 2002, Fannie had 23 counterparties for derivatives transactions. (*Dow Jones Newswire*, Julie Haviv, 11/13/02)

Fannie will not say specifically how it narrowed its duration gap

- Analysts noted that a selloff in Treasuries toward the end of September was an instrumental part of Fannie's recent narrowing of its duration gap. Goldman Sachs said that net mortgage purchases of \$20 billion would have narrowed the gap by two to three months, however, Fannie increased its purchases of receive-fixed swaptions from \$85 billion notional to \$125 billion. The amount Fannie paid fixed in swaps also decreased to \$193 billion from \$236.7 billion. "The net effect of the two would have been to shorten liability durations," Goldman Sachs said. (*Dow Jones Newswire*, Julie Haviv, 11/13/02) Fannie's spokeswoman Janice Smith declined to say specifically how Fannie narrowed its duration gap, citing a policy of not commenting on specific market activity. However, she said, "our mortgage commitments, mortgage purchases, hedging with swaps and swaptions [options on swaps], and callable securities are all vehicles we used to manage the duration gap." (*Dow Jones Newswire*, Julie Haviv, 11/17/02)

Fannie's holding of mortgages in its portfolio declines for a second time this year

- Fannie's holdings of mortgages declined in October for a second time this year, as refinancing increased, raising concerns that Fannie will not meet its portfolio growth target for 2002. The portfolio, which accounts for two-thirds of Fannie's profits, declined \$76 million, to \$751.3 billion. The annualized growth

rate fell to 7.6% in October from 8.5%, below the company's forecast for growth of 10 to 15%. (*Bloomberg News*, Heather Bandur and Al Yoon, 11/15/02)

FHFB to discuss in December adopting SEC-like disclosure standards for FHLBank debt securities and mortgage-backed securities (MBS) and multi-district FHLBank membership

FHFB “has initiated” discussions with the SEC and Treasury about potential disclosure expansion

In related news, Fannie & Freddie are working with the Federal Reserve, SEC, Treasury and OFHEO on efforts to expand their online financial disclosures

FHFB to consider disclosure standards for debt and MBS

- FHFB Chairman John Korsmo said he would like the FHFB to discuss adopting SEC-like disclosure standards for FHLBank debt securities and MBS and multi-district FHLBank membership at a public hearing next month. “The staff is working hard to draft a proposed regulation at our next meeting that will establish a state-of-the-art disclosure program for debt issued by the system and for any mortgage-backed securities issued by the banks if – and I stress the word ‘if’ – the Finance Board were at some point to approve such a request,” Korsmo said November 13. Currently none of the 12 FHLBanks issue MBS, but many industry observers believe that the success of the FHLBanks’ mortgage purchase programs (which compete with Fannie and Freddie) may eventually require them to do so. (*American Banker*, Rob Garver, 11/14/02)
- According to a FHLBank System finance report for the third quarter of 2002, the FHFB staff “has initiated discussions” with the SEC and the Treasury Department about potential expansion of the FHLBank System’s financial disclosures. However, the report noted that “due to the unique nature of the FHLBanks (the FHLBanks, as part of a cooperative system are not publicly traded corporations and the member financial institutions hold all FHLBank stock), changes in disclosure requirements for the FHLBanks, if any, have not yet been determined.” (*Dow Jones Newswire*, John Connor, 11/13/02)
- FHFB Chairman Korsmo indicated that the FHLBanks might go beyond Fannie and Freddie’s recent voluntary disclosure requirements and become “a role model” for GSE financial disclosures. (*Dow Jones Newswire*, John Connor, 10/22/02) The FHFB is expected to consider two rules to enhance financial disclosures: (1) addressing debt and MBS in the context of the 1933 Securities Act; and (2) addressing the registration of common stock within the context of the Securities Exchange Act of 1934, as advocated by Treasury Under Secretary Peter Fisher. Both rules would take effect in 2004. Korsmo said the first rule he would propose, with the target date of a December 11 board meeting, “will require the Office of Finance (which sells FHLBank debt) to bring the existing disclosure program for debt into line with SEC requirements under the Securities Act of 1933.” The rule would also cover MBS, if the board authorizes their issuance in the future. Bonds and MBS, however, would not be registered with the SEC or with the FHFB. “We recognize the unfeasibility of that suggestion,” he said. “Clearly, for an entity that issues 20 or 30 or 85 issues a day, it’s difficult to register those issues. Instead, the Finance Board will require a rigorous disclosure regime to inform and protect the public, and I think we can accomplish just that.” The second rule, with a target date of consideration at a January 8, 2003 meeting, “will deal with registration of stock under the Securities and Exchange Act of 1934,” said Korsmo. “The details of this proposal will be determined after a public hearing planned for December 2, with Finance Board directors and after consultation with the SEC,” Korsmo said. He said that before the effective date of any 1934 rules, “Each bank will have an opportunity to raise concerns with the SEC regarding compliance.” (*Dow Jones Newswire*, John Connor, 11/15/02)

Background on SEC disclosure of debt and MBS

- As noted in previous *GSE Reports*, on July 12, a voluntary financial disclosure agreement was reached among Fannie, Freddie, the SEC, OFHEO, and Treasury, in which Fannie and Freddie agreed to voluntarily register their common stock with the SEC (in compliance with the Securities Exchange Act of 1934), while retaining their exemption from registering their debt and MBS with the SEC (1933 Securities Act). Therefore, Fannie and Freddie will not register their debt or MBS with the SEC as do other publicly traded companies. The Treasury, SEC, and OFHEO are currently conducting a joint study that is expected to be completed by year-end to promote a more level-playing field with respect to initial offering disclosures between GSEs and non-GSE MBS issuers. In July 16 testimony before the House Capital Markets Subcommittee, Treasury Under Secretary of Domestic Finance Peter Fisher called on all GSEs to comply with the same SEC financial disclosure rules recently agreed to by Fannie and Freddie. In a follow-up to his testimony, Fisher sent letters in August to Sallie Mae and the 12 FHLBanks, urging them to comply with the same financial disclosure rules agreed to by Fannie and Freddie.

Fannie & Freddie are working with the Federal Reserve, SEC, Treasury and OFHEO on efforts to expand their online financial disclosures

- Fannie and Freddie are working with the Federal Reserve, OFHEO, and Treasury on efforts to expand their online financial disclosures, officials from the GSEs said November 5 in remarks at a Bond Market Association operations conference. Fannie said it is working with the Federal Reserve, Treasury, and OFEHO “to make sure we have an enhanced web-based disclosure process,” said Larry Barnett, Fannie’s Vice President for Securities Trading Operations. The SEC has also requested that Fannie ensure that it offers a “well-rounded” range of information online. Freddie said it is also working to improve its website and make more information available online. The FHLBank System has also expanded the amount of information available in its combined financial statements, said Michael Brown, the director of debt and credit systems in the FHLBank System’s Office of Finance. (*Dow Jones Newswire*, Rebecca Christie, 11/7/02)

FHFB to consider multi-district FHLBank membership

- Korsmo also indicated that the FHFB would consider multi-district FHLBank membership. “I also expect that at the December meeting the Finance Board will consider establishing a mechanism and a timeline aimed at bringing process to the debate on whether or not multiple bank membership should be extended to all members of the system,” Korsmo said. “This is a preliminary step only, but one that I believe is necessary if we, as the Finance Board, are to resolve the issue ultimately.” He believes that the debate about FHLBank membership should focus on whether multi-district membership enhances the safety and soundness and mission of the FHLBank System. (*American Banker*, Rob Garver, 11/14/02)

Background on multi-district FHLBank membership

- As noted in the May 3 and May 17, 2002 *GSE Reports*, Treasury Undersecretary for Domestic Finance Peter Fisher and then Treasury Assistant Secretary for Financial Institutions Sheila Bair stated that they do not believe the FHFB has the legal authority to allow institutions to belong to more than one FHLBank. [See May 3 and May 17, 2002 *GSE Reports* for more information, www.gsereport.com]
- Although the FHFB has never approved a bank for multi-district FHLBank membership, more than 100 bank holding companies have financial institutions in more than one of the 12 FHLBank System districts, and nearly 200 members of the FHLBank System have branches extending beyond district lines, according to Scott Smith, acting director of the FHFB’s Office of Policy Research and Analysis. (*BNA Daily Report for Executives*, Richard Cowden, 3/7/02)

FHFB Chairman John Korsmo says Fannie, Freddie, and the FHLBank System's implied government guarantee is worth billions of dollars

- Investors' assumption that taxpayers will stand behind GSEs, if necessary, "is worth many millions - no, actually billions" - to the owners of the FHLBanks and to homebuyers, FHFB Chairman John Korsmo said November 13 to a conference of FHLBank Directors. Korsmo noted that the assurance of federal backing is not found in the Congressional charters of Fannie, Freddie, or the FHLBanks. However, he added that "it is a very real market perception, as you well know." Korsmo said the marketplace's perception on which the implied guarantee rests could be shaken if the FHLBank System doesn't maintain the highest level of corporate behavior and a culture of responsibility. "We have to keep in mind that these are very large financial institutions," Korsmo said of the FHLBanks. "The average bank has assets of \$58 billion. All 12 of the banks are in the top 53 banking institutions in the country in terms of size of assets. Our largest bank, the Federal Home Loan Bank of San Francisco, has assets in excess of \$130 billion. The system in aggregate is a \$700 billion system with capital approaching \$35 billion. The implied federal guarantee to which Korsmo referred enables the FHLBanks and other GSEs to borrow at preferential rates compared to private enterprises. (*Dow Jones Newswire*, John Connor, 11/13/02)

HUD's Office of Policy Development releases new research studies

Study finds Fannie & Freddie are lagging the private markets in serving low-income, minority, and central city borrowers

- In its publication, *Cityscape*, HUD's Office of Policy Development and Research released studies providing perspectives on how Fannie and Freddie responded to their affordable housing goals during the first few years they were in effect. Fannie and Freddie's affordable housing goals were established in 1992 legislation. The opinions expressed in the studies are those of the authors and do not necessarily reflect the views of HUD or the US government. The articles are a product of small research grants that were made by HUD's Office of Policy Development and Research in 1997. *Cityscape's* first volume of GSE studies - "*Fannie Mae and Freddie Mac in the Housing Finance System: I*" - was published in 2001. A summary of the studies in the first volume was included in the September 7, 2001 *GSE Report*. In 2001, HUD funded an additional six research grants to expand studies on the GSEs. HUD published the next set of studies in 2002 - "*Fannie Mae and Freddie Mac in the Housing Finance System: II*" Studies in the first and second volumes found that Fannie and Freddie are lagging the private markets in serving low-income and minority borrowers. The following is a summary of the second set of studies"

"Spatial Variation in GSE Mortgage Purchase Activity"

- The study examined GSE purchases in 44 of the largest metropolitan areas between 1993 and 1996, comparing the GSEs with the primary mortgage market in specific market segments along borrower and neighborhood characteristics. **The study found that during the 1993-1996 period, compared with mortgages originated in the primary market, the GSEs were less likely to purchase loans made to:**
 - (1) Lower income borrowers relative to higher income borrowers;
 - (2) Minority borrowers relative to White borrowers;
 - (3) Borrowers in lower income neighborhoods relative to those in higher income neighborhoods;
 - (4) Residents of central cities relative to those in suburbs.
- Fannie and Freddie's market share, when compared to the non-GSE portion of the mortgage market, were relatively low among those borrowers who may have limited access to mortgage credit: lower-income borrowers, minority borrowers, borrowers in lower income neighborhoods, borrowers with high minority

concentrations, borrowers in central-city (versus suburban) neighborhoods, and borrowers in geographically targeted census tracts. Conversely, Fannie and Freddie's market shares were relatively high among those borrowers who are believed to have the greatest access to mortgage credit: higher income borrowers, White borrowers, borrowers in higher income neighborhoods, borrowers in predominantly White neighborhoods, borrowers in suburban neighborhoods, and borrowers in nontargeted census tracts.

- The study found that Fannie provided a relatively higher proportion than Freddie of total GSE funding for mortgage lending to lower income and minority borrowers and to borrowers living in lower income, predominantly minority, central city, and geographically targeted areas.
- The study included an analysis of clustering patterns and found that for a group of California and east coast metropolitan areas, the GSEs were more likely to have purchased relatively small loans and less likely to have purchased mortgages from relatively lower income borrowers during the study period. (*"Spatial Variation in GSE Mortgage Purchase Activity,"* Bradford Case, Board of Governors of the Federal Reserve System, Kevin Gillen and Susan Wachter, University of Pennsylvania, *Cityscape*, Volume 6, Number 1, 2002; *"Guest Editor's Introduction,"* John Gardner, Paul Manchester, HUD's Office of Policy Development and Research)

"Government-Sponsored Enterprise Secondary Market Decisions: Effects on Racial Disparities in Home Mortgage Loan Rejection Rates"

- The study examined racial disparities in mortgage lending as related to the rates at which minority and non-minority first-time homebuyer loans are sold to the GSEs in the 23 largest metropolitan statistical areas (MSAs). Earlier studies found that racial minorities – particularly Blacks and Hispanics – were less likely to be approved for home mortgage loans than non-minorities. The disparities may reflect differences in credit risk or property values. Lenders have cited the difficulty of selling loans to the GSEs on the secondary market as a factor accounting for higher rejection rates of minority applicants. The study found that the probability that a loan will not be sold on the secondary markets systematically increases the probability that the lender will reject a loan application. Loans taken out by Blacks and Hispanics are less likely to sell on the secondary market than are loans taken out by Whites. However, the study found that no consistent evidence supported the hypothesis that GSE decisions systematically explain observed racial disparities in loan rejection rates. In many MSAs, the GSE effect can account for some of the high rejection rates of Blacks and "others." However, among other racial groups, there are as many MSAs where there is no such finding as there are MSAs where the effect seems to hold. Even when the effect seems to hold, the amount explained is small. The study found that the impact is so small that even large differences in actual probabilities that loans are not sold to the GSEs cannot explain the substantial racial differences in loan rejection rates. (*"Government-Sponsored Enterprise Secondary Market Decisions: Effects on Racial Disparities in Home Mortgage Loan Rejection Rates,"* Samuel L. Meyers, Jr., Hubert H. Humphrey Institute of Public Affairs, University of Minnesota; *Cityscape*, Volume 6, Number 1, 2002; *"Guest Editor's Introduction,"* John Gardner, Paul Manchester, HUD's Office of Policy Development and Research)

"Mitigating Information Externalities in Mortgage Markets: The Role of Government-Sponsored Enterprises"

- The study is based on the theory of information externalities, which suggests that property transactions in a particular market area generate information that makes similar future transactions in that same market less risky for prospective borrowers. Specifically, home sales information enables independent appraisers to generate more precise value estimates, which in turn, reduces the uncertainty and risk faced by lenders, thereby potentially increasing acceptance rates for mortgage applications and increasing the flow of mortgage funds to the given market area. Using a sample of GSE purchasing activity in 12 Florida counties, the study found some evidence that Fannie and Freddie are more active in neighborhoods with historically low transaction volume than they are in other neighborhoods. A similar result is found when the analysis is restricted to loans with high impaired payments relative to borrowers' income. The study also found that

Fannie is more active than Freddie in neighborhoods with high vacancy rates and in lower priced neighborhoods. (“*Mitigating Information Externalities in Mortgage Markets: The Role of Government Sponsored Enterprises*,” David Harrison, University of Vermont, Wayne R. Archer, David C. Ling, and Marc T. Smith, University of Florida; *Cityscape*, Volume 6, Number 1, 2002; “*Guest Editor’s Introduction*,” John Gardner, Paul Manchester, HUD’s Office of Policy Development and Research)

“The Patterns of GSE Participation in Minority and Racially Changing Markets Reviewed from the Context of the Levels of Distress Associated with High Levels of FHA Lending”

- The study found that although the Chicago and Washington, DC areas had similar proportions of minorities in their populations, minority areas in the Chicago area had lower levels of GSE purchases than did White areas, but minority areas in the Washington, DC area had about equal, and sometimes higher, levels of GSE purchases relative to White areas. The study interpreted this finding as partially resulting from the large minority population in the Washington, DC area living in rapidly growing new development and suburban locations when compared to the minority population distribution in the Chicago area. In both markets, the GSEs have tended to concentrate their purchases in rapid-growth sections, which are generally more attractive to lenders and secondary market investors. (“*The Patterns of GSE Participation in Minority and Racially Changing Markets Reviewed from the Context of the Levels of Distress Associated with High Levels of FHA Lending*,” Calvin Bradford, Calvin Bradford & Associates, Ltd.; *Cityscape*, Volume 6, Number 1, 2002; “*Guest Editor’s Introduction*,” John Gardner, Paul Manchester, HUD’s Office of Policy Development and Research)

“Some of the neediest borrowers may find themselves paying even more as a result of GSE entry into the subprime market,” says Center for Community Change General Counsel Allen Fishbein

“Since so much of mortgage lending is affected directly or indirectly” by Fannie and Freddie’s automated underwriting [AU] systems, HUD’s release of its fair lending review of Fannie and Freddie’s AU systems is “long overdue” and “fair housing and affordable housing groups should press for this information to be released.”

HUD expects to release its fair-lending review of Fannie & Freddie’s AU systems by year-end - HUD has been investigating Fannie & Freddie’s AU system for fair lending violations since 1999

Class action lawsuits have been filed against Fannie & Freddie’s AU systems

- “Some of the neediest borrowers may find themselves paying even more as a result of GSE entry into the subprime market,” said Center for Community Change General Counsel Allen Fishbein in an article for the National Housing Institute’s *Shelterforce* publication. Fishbein noted that the subprime market has grown rapidly in the past decade and “interestingly, subprime market growth in the 1990s occurred largely without the participation of Fannie Mae and Freddie Mac.” The two GSEs began showing interest in this market toward the end of the decade and are now purchasing A-minus mortgages as a regular part of their business. He noted that some market analysts estimate that Fannie and Freddie will soon be purchasing as much as one-half of all subprime originations.
- The GSEs have entered the subprime market because their traditional conforming mortgage market has matured, and they are looking for new ways to increase profits and meet investors’ expectations. Because Fannie and Freddie’s GSE charters allow them to raise funds more cheaply than fully private financial institutions, the GSEs “can be expected to expand their market share by outpricing their competitors.” Fannie and Freddie are also attracted to the subprime market by their desire to find new applications for their AU systems. In order to enter the subprime market, Fannie and Freddie have to modify their AU systems so that the prime lenders they deal with can approve slightly higher-risk borrowers, whose

applications would not have been accepted in the past. The GSEs then charge lenders higher fees for making these loans, and mortgage originators in turn may pass these higher costs along to borrowers. Using AU to set prices for making loans with different risks “is a form of risk-based pricing” and “represents an important change in the way the GSEs have traditionally operated their prime loan business.”

- Fishbein explained, “For the most part prime mortgage borrowers are charged interest rates based on... ‘average loan pricing.’ In other words, a borrower approved for a mortgage receives about the same interest rate regardless of the risk of loss to the lender. The risk for all prime lenders, from the lowest to the highest, is averaged, and the interest rate is set based on the average risk.” Under risk-based pricing, on the other hand, “borrowers are bunched in smaller pricing buckets based on their calculated risks and potentially other facts, such as the loan’s expected life-time rate of return.”
- Under risk-based pricing, some of the neediest borrowers are expected to pay more. Fishbein explained, “As the price declines for certain subprime loans, the traditional distinctions between prime and subprime loans will become less important. The price of mortgages formerly considered subprime will be based instead on the ease with which they can be sold to one of the GSEs. However, other subprime loans, such as the B and C loans that GSEs do not buy, may become more expensive for borrowers. As the GSEs capture the market for less risky subprime borrowers, it will leave fewer of them available to cross-subsidize the costs of making subprime loans to more risky borrowers. Subprime lenders, therefore, are likely to attempt to recapture their loss of income by raising rates for the segment of the market they continue to serve. Thus, some of the neediest borrowers may find themselves paying even more as a result of GSE entry into the subprime market.” Fishbein added that “Risk-based pricing for subprime loans may also hasten the demise of average pricing for prime lending as well,” which would “benefit some borrowers, but lead to others [e.g., borrowers that barely qualify for a conventional prime loan] paying more.”
- Fishbein, who worked at HUD from 1999-2000 as a senior advisor for GSE oversight, recommended that HUD release its fair lending review of Fannie and Freddie’s AU systems since the “movement to risk-based pricing for mortgages raises fundamental concerns about whether the AU systems are biased against minorities and other protected classes.” Fishbein noted that “Indications are that credit-scoring tends to work against families with limited or alternative credit histories, which are disproportionately represented by African-American and Hispanic households.” Fishbein added that “Since so much of mortgage lending is affected directly or indirectly by these automated underwriting systems, HUD’s release of its fair lending review of Fannie and Freddie’s AU systems is ‘long overdue’” and “fair housing and affordable housing groups should press for this information to be released.”
- Fishbein also suggested HUD enhance its ability to monitor the GSEs’ increased purchasing of subprime loans. “It is ironic that with all of the talk in Washington about investor need for greater transparency about the capital market activities of the GSEs, the discussion does not extend to finding ways to improve the monitoring of their loan purchase activity. Yet this is precisely what is needed to judge the impact of automated underwriting, risk-based pricing and increased GSE subprime activity on affordable housing and credit access by underserved groups.” (*National Housing Institutes’ Shelterforce*, September/October 2002, Allen Fishbein)

HUD expects to release its fair-lending review of Fannie & Freddie’s AU systems by year-end

- As noted in the November 1, 2002 *GSE Report*, HUD Secretary Mel Martinez said that he will soon release the results of HUD’s fair lending review of Fannie and Freddie’s AU systems. (*Reuters*, Mark Felsenthal, 10/22/02)
- HUD has been investigating Fannie and Freddie’s AU systems since 1999. In February 1999, HUD sent letters to Fannie and Freddie requesting information to ensure that the GSEs’ systems comply with fair-

lending standards. The GSEs did not release the requested information until January 31, 2000 after assurances from HUD that it would keep Fannie and Freddie’s proprietary information private. In March 1999, HUD commissioned an independent study by the Urban Institute, which found that Fannie and Freddie’s underwriting guidelines may inadvertently have a disparate impact on minority borrowers. The report also noted that Fannie and Freddie “do not appear to have gone as far as some primary lenders to serve low-income and moderate-income borrowers and to minimize disproportionate effects on minorities.” The report found that “Primary lenders are making more aggressive efforts” to serve the lower income and minority homebuyers “by offering loan products with underwriting guidelines that are more flexible than the GSEs’ guidelines.” Further, the report noted that “depository lenders are serving low- and moderate-income borrowers better than the GSEs and so the percentage of loans purchased by the GSEs that are originated to low- and moderate-income borrowers is less than the percentage of loans originated in the primary market.” The report also advised that “there is some evidence that the GSEs’ purchase of loans made to black and Hispanic homebuyers have actually declined (in share and absolute number) over the last two years.” (*HUD/Urban Institute Study, “A Study of the GSEs’ Single Family Underwriting Guidelines,”* April 1999)

- A 2001 Mercer Management Consulting study found that Fannie and Freddie’s AU systems resulted in approval of a smaller percentage of loans for minorities than AU systems created by other companies. [See March 30, 2001 *GSE Report* for more information, www.gsereport.com] Finally, former Treasury Under Secretary Gary Gensler testified on March 22, 2001 that the GSEs’ AU systems are increasingly becoming the means by which originators decide to lend, which may result in less diversity in credit decisions and less price competition.

Class action lawsuits filed against Fannie & Freddie’s AU systems

- As noted in the November 1, 2002 *GSE Report*, a class action lawsuit was filed in the US District Court in Philadelphia alleging that Freddie’s AU system – Loan Prospector – violates the federal Fair Credit Reporting Act (FCRA) by failing to inform certain borrowers that their interest rate quotes are higher than standard because of problems detected in their credit files. (*Realty Times*, Kenneth Harney, 10/28/02; *Washington Post*, Kenneth Harney, 10/25/02) [See November 1, 2002 *GSE Report* for more information, www.gsereport.com]
- The class action lawsuit against Freddie’s AU system came shortly after a class action lawsuit was filed against Fannie. As noted in the September 27 and October 11, 2002 *GSE Reports*, the class action lawsuit alleges that Fannie engaged in discriminatory lending practices based on its AU system, Desktop Underwriter (DU). The lawsuit charged Fannie with violating the Fair Housing Act, the Equal Credit Opportunity Act and the Fair Credit Reporting Act. (*Dow Jones Newswire*, Dawn Kopecki, 9/25/02) [See September 27 and October 11, 2002 *GSE Reports* for more information, www.gsereport.com]

Investigation into FHFB Chairman John Korsmo’s participation in a political fundraiser may go beyond the ethics of his involvement into a serious legal issue, reports the *American Banker*

Korsmo has been criticized for being a special guest at a political fundraiser to which Presidents of the FHLBanks were asked to contribute

Outside attorney who helped the FHFB develop its ethics rules tells FHFB Inspector General that Korsmo’s participation at the fundraiser was “lawful and appropriate”

- An investigation into Korsmo’s participation in a political fundraiser may go beyond the ethics of his involvement into a serious legal issue, reported Rob Garver with the *American Banker*. Korsmo recently disclosed in an October 30 letter to Senate Banking Committee Chairman Paul Sarbanes (D-MD) that he had acquired information about the political contributions of FHLBank executives. Federal investigators are

currently examining data taken from computers belonging to Korsmo and his staff as part of an examination requested by Senator Sarbanes. “If they discover that Finance Board employees gathered information about donations on his behalf, Mr. Korsmo faces a no-win situation,” reported Garver. Korsmo’s admission in the October 30 letter “raises a delicate legal issue” because he is subject to the Hatch Act, which regulates the political activity of government workers. Garver explained, “If he [Korsmo] claims that the information was gathered as part of his job as the lead regulator of the Home Loan Banks, the question would be why he believed such political information was necessary for him to perform his duties as a supervisor. On the other hand, if he claims that the information was gathered for a nonregulatory purpose, Mr. Korsmo could leave himself and members of his staff open to the accusation that they violated” the Hatch Act. (*American Banker*, Rob Garver, 11/6/02)

- Anna Galindo-Marrone, the lead attorney for the Hatch Act Unit of the US Office of Special Counsel offered no opinion on Korsmo’s conduct but noted that most Senate-confirmed presidential appointees are not prohibited from gathering information for political purposes while on the job. However, a presidential appointee who asked staff to gather information for a political purpose could be accused of violating the Hatch Act’s prohibition on using official authority to coerce any person to participate in political activity. (*American Banker*, Rob Garver, 11/6/02)
- In a telephone conversation with *National Mortgage News*, Korsmo insisted his staff only provides him with media clips about individuals and others he is planning to meet and that he himself occasionally looks up other information, such as campaign contributions on the Internet. “That is me not staff,” he clarified – “I get all kinds of information about people that I think is valuable when I have to have a relationship with them.” (*National Mortgage News Daily website*, 11/5/02)

Background

- As noted in previous *GSE Reports*, Korsmo has come under criticism for being a special guest at an October 1 fundraiser for Rick Clayburgh, a friend of Korsmo, who was running as a Republican for Congress from North Dakota. Korsmo’s attendance was criticized because the presidents of several FHLBanks were invited to the fundraiser, just weeks after the FHFBS adopted new ethics rules that declared the FHFBS to be the “arms-length regulator for the safety and soundness” of the FHLBanks. (*American Banker*, Rob Garver, 10/1/02) Korsmo said he had checked prior to the fundraiser with his general counsel, Arnold Intrater, and Greg Walden, a Washington attorney who helped the FHFBS develop its ethics rules. (*Associated Press*, Dale Wetzel, 10/2/02) [See the October 11, 2002 and November 1, 2002 *GSE Reports* for more information about Korsmo’s participation at the fundraiser, www.gsereport.com]
- House and Senate lawmakers requested a federal investigation into Korsmo’s participation in the fundraiser. Senate Banking Committee Chairman Paul Sarbanes (D-MD) and Ranking Member Phil Gramm (R-TX) sent letters to the Government Accounting Office, the FHFBS’s Inspector General and Korsmo requesting a federal investigation. Congressman Henry Waxman (D-CA) also sent a letter to the House Government Reform Committee Chairman Dan Burton (R-IN) raising concerns about Korsmo’s participation in the fundraiser. Federal investigators searched the FHFBS offices and seized computer data on October 28 as a routine part of the federal examination.

Outside attorney tells FHFBS Inspector General that Korsmo’s participation at the fundraiser was “lawful and appropriate”

- Walden, who Korsmo consulted prior to the fundraiser and helped the FHFBS develop its ethics rules, wrote a letter to FHFBS Inspector General Edward Kelley stating, “I advised the chairman...that his appearance at the event and his name on the invitation would be lawful and appropriate under the ethics laws and policies governing executive branch officers and employees subject to certain conditions. Those conditions were met...In my opinion, no criticism of Mr. Korsmo is warranted. Indeed, Mr. Korsmo ought to be given

credit for seeking advice from his general counsel and from the undersigned in advance of the event.”
(*National Mortgage News*, Brian Collins, 11/11/02)

Fannie Mae and Freddie Mac

GSE debt news:

- (1) First Tennessee is the top underwriter of US agency debt from July 1 – October 31**
- (2) Freddie to buy back some of its euro-denominated debt**

Background on GSE debt and the supply of Treasurys

- Over the past few years, as the US was running budget surpluses, and the national debt was being paid down, the supply of Treasury securities shrunk. Investors, traders, borrowers, and even the US Federal Reserve were being forced to find new benchmark securities to replace the shrinking number of Treasurys. Among possible alternatives as a benchmark were: (1) the debt securities of Fannie and Freddie; (2) derivatives tied to the swaps market; or (3) high-grade corporate bonds. Investors view the debt securities of Fannie and Freddie as “almost” as good as US Treasurys because of the implicit government guarantee of Fannie and Freddie’s securities. Fannie and Freddie began bond issuance programs (Fannie – Benchmark bond program; Freddie- Reference bond program) to mirror traditional Treasury operations in size and regularity as an alternative benchmark. Given the expected budget deficits in the next few years, resulting in increased issuance of Treasurys, the search for alternative benchmark investments may be lessened.

First Tennessee is the top underwriter of US agency debt from July 1 – October 31, 2002

- Since June, First Tennessee has become the number one bond underwriter for Fannie, Freddie, the FHLBank System, and the Federal Farm Credit Bank, reported Al Yoon with *Bloomberg*. First Tennessee is in the number one spot because it has focused on bonds sold with call options, said Jim Vogel, a vice president of agency research at FTN Financial, First Tennessee’s securities and underwriting unit. The GSEs have been selling more callable bonds. During the past four months, FTN Financial has handled 660 agency debt sales worth \$22.69 billion, according to *Bloomberg* data. Merrill Lynch – the number one in this field for at least four years – has underwritten 262 issues, worth \$21.25 billion. Merrill is still the leader for the entire year; First Tennessee has moved up to the sixth spot from 10th in 2001. The following are the top 10 underwriters of US agency debt from July 1, 2002-October 31, 2002: (\$ billion) (% market share): (1) FTN Financial, \$22.69, 8.0%; (2) Merrill Lynch, \$21.25, 7.5%; (3) UBS Warburg, \$19.64, 6.9%; (4) Lehman, \$18.55, 6.5%; (5) Goldman Sachs, \$17.52, 6.2%; (6) Morgan Stanley, \$15.19, 5.3%; (7) Salomon, \$14.28, 5.0%; (8) CSFB, \$13.90, 4.9%; (9) Morgan Keegan, \$13.71, 4.8%, and (10) Bear Stearns, \$13.54, 4.8%. (*Bloomberg News*, Al Yoon, 11/4/02)

Freddie to buy back some of its euro-denominated debt

- Freddie plans to repurchase some of its euro-denominated debt to manage its debt portfolio, reported Tom Kohn with *Bloomberg*. Each buyback won’t be more than 20% of an issue, and won’t leave a bond with less than 3 billion euros outstanding, the GSE said. The GSE expects the debt to still trade on the EuroMTS system, which requires bonds of at least 5 billion euros for banks to make markets in them. Since June 2001, Freddie has repurchased \$14.5 billion of its inactively traded US-denominated bonds, known as off-the-run issues. Freddie has sold \$13.8 billion of euro-denominated bonds this year. (*Bloomberg News*, Tom Kohn, 11/6/02)

Fannie Mae

Fannie Mae Foundation names former staffer from Senator Edward Kennedy's (D-MA) office as Vice President of Leadership and Practice Development

- The Fannie Mae Foundation announced November 13 that it has appointed Sheila F. Maith as Vice President of Leadership and Practice Development. Prior to joining the Fannie Mae Foundation, Maith worked on Senator Kennedy's staff where she was senior counsel on the Health, Education, Labor and Pensions Committee and supported the Senator's work on national and local economic issues. Prior to her work with Senator Kennedy, she served as Director of Federal Policy for Local Initiatives Support Corporation (LISC). Maith also previously served as program director at the Enterprise Foundation. (*Fannie Mae Foundation press release*, 11/13/02)

Freddie Mac

Freddie announces that its third quarter 2002 earnings increased by \$160 million, after reducing its reserves for loan losses by \$246 million

- Freddie said that its third quarter 2002 earnings increased by \$160 million, after reducing its reserves for loan losses by \$246 million. Freddie estimated in July that its reserves were approximately \$250 million more than required, making such a reduction possible. At the time, Freddie said it was reviewing the accounting change with the SEC. After getting SEC approval for the move, Freddie was able to reduce these reserves by \$246 million pretax, to \$462 million, resulting in a net gain of \$160 million to earnings after tax. Third quarter 2002 income increased to \$1.38 billion, or \$1.90 a share, from \$1.03 billion, or \$1.40 a year earlier. Freddie also reiterated its forecast to post 20% growth in operating earnings per share this year, excluding the effects of the reserve reduction. The change didn't affect financial results prior to the third quarter, the GSE said. (*Bloomberg News*, Al Yoon, 11/14/02; *American Banker*, 11/18/02) Freddie previously reported third quarter earnings of \$1.38 billion, or \$1.90 a share, on revenue of \$2.20 billion. (*Dow Jones Newswire*, Susan Willetts, 11/14/02) [See November 1, 2002 *GSE Report* for Freddie's previously reported third quarter earnings, www.gsereport.com]

Federal Home Loan Banks

FHLBank System's debt and membership continue to grow in the third quarter

- The FHLBank System's consolidated debt obligations outstanding increased 7.4% since year-end 2001, rising to \$667.6 billion at September 30, 2002, according to a new financial report on the FHLBank System's finances for the third quarter of 2002. The System's membership increased to 7,992 members at September 30, a net increase of 115 from the end of last year. The FHLBank System's investments also increased \$25.3 billion, or 13.3% to \$215.5 billion at September 30 from a year-end 2001 balance of \$190.2 billion. The System's investments include mortgage-backed securities, overnight and term federal funds sold, commercial paper, agency securities, and US government securities. Aggregate mortgage-backed securities investments at September 30 were \$95.5 billion. Mortgage loans held by the FHLBanks increased to \$47.1 billion at September 30 from \$27.7 billion at December 31, 2001, and from \$22.6 billion at September 30, 2001. (*Dow Jones Newswire*, John Connor, 11/13/02)

Farm Credit System/Farmer Mac

Commercial banks should be concerned about the rapid consolidation of farm credit lenders because the larger farm credit lenders are using their resources to “cherry-pick” banks’ customers, says financial consultant Bert Ely

Ely claims “almost all of the loan growth in recent years has flowed to larger, wealthier, and older borrowers, making a mockery” of the Farm Credit System’s mission

- Commercial banks should be concerned about the rapid consolidation of farm credit lenders because the larger farm credit lenders are using their resources to “cherry-pick” banks’ customers, said financial consultant Bert Ely in a November 11 speech at the American Bankers Association’s agricultural bankers conference. “As they [farm credit lenders] walk away from serving smaller farmers, they have an increasing focus on going after large credits.” The number of lenders in the Farm Credit System has fallen from close to 1,000 two decades ago to about 100 today, and Ely predicted that there could be as few as 20 farm credit lenders by 2010.
- Michael M. Reyna, the chairman and chief executive officer of the Farm Credit Administration, claimed the trend reflects the consolidation in the agricultural industry, and he insisted that farm credit lenders are not abandoning the GSE’s mission of providing low-cost credit to rural America. In a report issued at the conference, Ely noted, however, that “almost all of the loan growth in recent years has flowed to larger, wealthier, and older borrowers, making a mockery of the System’s legal obligation to serve young, beginning, and small farmers.” He cited a General Accounting Office report released in March, which noted that more than two-thirds of the farm credit lending institutions surveyed did not have “measurable goals” for serving young or beginning farmers and that half did not have marketing outreach efforts. Ely called for “complete privatization” of the Farm Credit System. Reyna said that the Farm Credit System’s mission is to serve all of rural America, not just young and beginning farmers. Nevertheless, he said the Farm Credit Administration is addressing the issues raised in the GAO report and plans to hold a hearing in Kansas City November 13 on how to better serve young and beginning farmers. (*American Banker*, Ben Jackson, 11/13/02)

Ginnie Mae

Ginnie Mae proposes lowering fees associated with some of its mortgage-backed securities

Ginnie Mae proposes new policy for repurchasing of delinquent loans

- Ginnie Mae proposed November 5 changes to its mortgage-backed securities program, to be effective July 1, 2003. Major changes include: (1) reducing the spread of note rates eligible for securitization within a Ginnie Mae II pool to 25-75 basis points above the security rate; (2) setting the minimum servicing fee for a Ginnie Mae pool or loan package to 19 basis points from 44 basis points; (3) establishing the Ginnie Mae II security payment date for newly issued pools as the 15th of the month; (4) requiring that buydown loans may comprise no more than 10% of the Original Principal Balance of a Multiple Issuer loan package. (*InfoBytes*, Goodwin Procter LLP, 11/15/02)
- According to Ginnie Mae President Ronald Rosenfeld, the proposed changes stemmed from President Bush’s June 2002 call to add 5.5 million minority families to the roles of homeowners by the end of the decade. Rosenfeld said these proposed changes will help meet the President’s goal by streamlining processes

and making the securities more attractive to investors. HUD's press release noted that "the 30-year old rationale for the 44 basis point reserve was to protect Ginnie Mae in the event of a default by issuers, which would put the task of servicing on Ginnie Mae or its designee. Under the terms of the proposal, issuers will have the option of passing along this savings, which reduces the cost of servicing, to homeowners." (*HUD press release, 11/5/02*)

- When the changes are implemented, the Ginnie Mae II security will more closely resemble the Ginnie Mae I security, which has been a flagship of the mortgage finance market for more than 30 years. The GNMA I program features securities backed by mortgages at one rate, with both the issuers receiving a fixed servicing fee and investors receiving their return on the 15th of each month. (*HUD press release, 11/5/02*)
- Ginnie Mae notified program participants of the proposed changes November 1 by letter, and posted the changes on its website (www.ginniemae.gov) In addition, senior staff will meet with members of lending institutions in Los Angeles, Dallas, Atlanta, Detroit and New York City to discuss the changes. Ginnie Mae will accept comments on the proposal through year-end. (*HUD press release, 11/5/02*)

Ginnie Mae proposes new policy for repurchasing of delinquent loans

- Ginnie Mae also issued a November 6 memorandum regarding its new policy for repurchasing of delinquent loans. For loans placed in pools with an issue date of January 1, 2003, and thereafter, issuers may no longer repurchase pooled loans when at least one missed payment remains uncured for four consecutive months. The only occasion in which issuers may repurchase delinquent loans is when no payment is made for three consecutive months. (*HUD/Ginnie Mae Memorandum from George Anderson, EVP, Ginnie Mae, 11/6/02*) Ginnie Mae noted that the announcement is final, reflecting Ginnie Mae's position that they have considered issuers' views. The Mortgage Bankers Association discussed various aspects of the change with Ginnie Mae and recommended that the revised buyout policy should not apply to existing pools. The Ginnie Mae memorandum states that the policy change is prospective in nature. (*MBA Member Alert, 11/6/02*)

Postal Service

Postal Service seeks pension legislation that would save the Postal Service money and could delay a postal rate increase until 2006

Postal Service and the Office of Management and Budget have signed off on legislation

Congressman John McHugh (R-NY) requests the General Accounting Office (GAO) review the legislation

- The Postal Service is seeking pension legislation that would save the Postal Service money and could delay a postal rate increase until 2006, postal officials told the Postal Service Board of Governors November 5. The proposed legislation would change the funding formula for employee retirement benefits. Postal officials discovered in a recent financial analysis of Postal Service retirement payments going back to 1971 that the Postal Service is on course to amass a balance of \$243.6 billion in the Civil Service Retirement System (CSRS) fund. That is far more than the \$172.6 billion that actuaries said the Postal Service needs to cover the cost of future employee retirements. The fund's current balance is \$151.1 billion. "Therefore, under the current legislation, Postal Service contributions would over fund CSRS costs by \$71 billion if left unchanged," said Postmaster General John Potter. Legislation is needed to change the payment schedule into the employee retirement plan. If Congress approves such legislation, the Postal Service could delay a postal rate increase until 2006, two years later than previously predicted. (*Washington Post, Christopher Lee, 11/5/02*)

- The anticipated savings - \$2.9 billion for FY 2003 and \$2.6 billion every year thereafter – would push the Postal Service, which has an annual budget of \$70 billion, well beyond the \$600 million surplus officials expect for FY 2002. And it would increase the amount available for debt reduction from \$800 million to more than \$3 billion, Potter said. (*Washington Post*, Christopher Lee, 11/6/02)

Postal Service and OMB have signed off on legislation

- The Office of Personnel Management (OPM) prepared a bill called the Postal Service Retirement System Funding Reform Act of 2002. The Postal Service and the Office of Management and Budget have signed off on the bill, which was brought to Capitol Hill the week of November 11. (*DM News*, Melissa Campanelli, 11/18/02) Speaking in a November 7 teleconference, Postal Service Chief Financial Officer Richard Strasser warned that if legislation isn't passed during the upcoming lame-duck session of Congress, "we will begin gearing up to prepare a rate filing in January that we can file [with the PRC] in the spring." (*DM News*, Melissa Campanelli, 11/7/02) Mailers do not think the legislation will be taken up until after the new congressional session begins in January. "If it did get passed during a lame-duck session, it will be because the White House also applied some pressure to the folks up on Capitol Hill to get this done now," said Neal Denton, Executive Director of the Alliance of Nonprofit Mailers. (*DM News*, Melissa Campanelli, 11/18/02)
- Postal Service Board of Governors Chairman Robert Rider said he and others on the panel "will do everything in our power to assist the administration in bringing about this legislative change. It is in the best interests of everyone to have this occur and to have it occur as soon as possible." (*Washington Post*, Christopher Lee, 11/5/02)
- Postal Service officials and executives from the Mailers Council, Direct Marketing Association and the Alliance of Nonprofit Mailers began meeting the week of November 11 with the Senate Committee on Governmental Affairs and the House Committee on Government Reform. (*DM News*, Melissa Campanelli, 11/18/02)

Passage of legislation may be difficult

- One problem with the bill is that a decrease in postal contributions would be viewed as less income to the federal budget and, therefore, technically would add to the budget deficit. Essentially, "this savings generates a \$3 billion shift in the unified budget," said Neil Denton, Executive Director of the Alliance of Nonprofit Mailers. "[Congress] is going to have to find \$3 billion in costs somewhere...Anyone who is dancing naked in the streets thinking that their rates will be frozen until 2006 hasn't spent any time on Capitol Hill. There is still a significant hurdle to be cleared here." (*DM News*, Melissa Campanelli, 11/18/02)
- Chairman of the Senate Governmental Affairs Committee Senator Joseph Lieberman (D-CT), who had pushed for reviews of the Postal Service's pension liability, said any money saved should be used to pay down the Postal Service's debt of more than \$11 billion. "This legislation will not be easy to accomplish," he said, "but the support of the administration will be critical to its chances of passage." (*Washington Post*, Christopher Lee, 11/6/02)

Congressman McHugh requests GAO analyze the legislation

- Robert Traub, Chief of Staff for Congressman John McHugh (R-NY) attended a briefing by the OPM, Treasury Department, and the Postal Service and Congressman McHugh met with Postmaster General John Potter. "I think the bottom line is the one entity that has not been heard from or included in this process – although they were the ones that started this process and suggested that OPM should begin this analysis – is the General Accounting Office (GAO)," Traub said. "McHugh has requested that GAO evaluate this analysis and the legislation and let Congress know what they think."

- The financial analysis of pension payments was undertaken by the OPM at the request of the GAO and the Postal Service, Postmaster General John Potter said. (*Washington Post*, Christopher Lee, 11/5/02)
Comptroller General David Walker said the GAO had not had time to audit the analysis. “There is still a need for postal transformation,” Walker said. “This may give them a little more breathing room, but the underlying market trends and the other challenges that the Postal Service faces have not gone away.” (*Washington Post*, Christopher Lee, 11/6/02)

Direct Marketing Association (DMA) supports the legislative change

- “We are pleased about the possible delay in any future rate increase and call on Congress to enact the necessary legislative change to fix this broken system quickly,” said H. Robert Wientzen, president and CEO of the DMA. “We will work with the Postal Service and others to affect necessary changes which will ensure that the American mailing public receives the lowest possible mailing rates.” (*PR Newswire*, 11/5/02)
- “This fiscal windfall should not, however, be misconstrued as a long-term salvation of the Postal Service,” added Wientzen. “As noted today by the Postmaster General, the fact remains that Congress and the Administration need to look at fundamental reform of the 32-year-old law that governs all Postal Service functions. Without this type of fundamental reform, the Postal Service will not be able to compete in the 21st century electronic and private delivery marketplace as a provider of communications services,” said Wientzen. (*PR Newswire*, 11/5/02)

Magazine Publishers of America (MPA) support the legislative change

- “The MPA welcomes the excellent financial news that came from today’s Postal Service Board of Governors meeting...We note with caution however, Mr. Potter’s call for early enactment of the legislation that will be necessary to insure postal rate stability until 2006. MPA will lend its full support to the effort to win passage of this legislation. We continue to believe that the President should appoint a commission to study the future of the nation’s postal system,” Nina Link, President & CEO, MPA said. (*Business Wire*, 11/5/02)

Government Accounting Office (GAO) recommends the Postal Service enhance its financial reporting

**GAO compared the Postal Service’s financial reporting with two of its publicly traded competitors—
FedEx and UPS**

Postal Service plans to enhance its financial disclosures

- In response to a July 31, 2002 request by Senators Daniel Akaka (D-AK) and Thad Cochran (R-MS), the GAO issued a report on the Postal Service’s actions to improve its financial reporting. Senator Akaka is the Chairman of the Subcommittee on International Security, Proliferation, and Federal Services of the Governmental Affairs Committee. Senator Cochran is the Ranking Minority Member.
- The GAO found that although the Postal Service has “traditionally provided a range of detailed financial and operating data to stakeholders throughout the fiscal year, its periodic financial reports have not clearly explained changes in its financial condition, results of operations, and outlook and have not always been readily available to the public.” In response to the GAO’s recommendation to enhance financial disclosures, the Postal Service committed to provide quarterly financial statements “similar to what publicly traded enterprises provide.” The Postal Service also began posting its quarterly reports on mail volumes and revenues, along with its monthly operating statements, to its Web site. The GAO noted, however, that it does “not believe that the quarterly financial reports provided to date meet the intent of our

recommendations, because the Service provided only limited analysis and explanations to help stakeholders understand what had changed, why it had changed, and how these changes affected the Service's current financial situation and expected outlook.”

- The GAO noted that the SEC requires that quarterly reports submitted by publicly traded companies include a discussion of material changes in a company's financial condition and results of operations, which is consistent with the intent of the GAO's recommendations. However, when the GAO compared the Postal Service's most recent quarterly report with those of two of its publicly traded competitors—FedEx and UPS - they “found that the Service's quarterly report generally provided the same basic financial statements as did its competitors. However, unlike the Service, FedEx and UPS also provided very detailed ‘Management's Discussion and Analysis’ sections in their reports that discussed events during the period that may have had a significant impact on the financial condition of the company and the outlook for the future, and compared the results of operations with the prior year's results.” The GAO further noted that “FedEx and UPS's reports also included explanatory footnotes to the financial statements that provided details about significant changes that have occurred and material contingencies that were not included in the Service's reports. Further, the Service's quarterly reports were not consistent in format and content, or as available to the public as the FedEx and UPS quarterly reports.” The GAO noted “these changes in subsequent quarterly reports and their limited availability made it difficult to make comparisons and analyze trends.”
- The Postal Service said that it would provide additional information in its periodic financial reports to improve stakeholder understanding of its business and that it would retain the data on its website for 3 years. The Postal Service also cautioned that public discussion of retirement obligations must be undertaken with great care, and that it would ensure greater public understanding in this area. The GAO responded that “Due to the magnitude of these costs, the potential effects on current and future ratepayers, and the complexity of the issues involved in reporting retirement-related obligations, we agree that greater public understanding of these obligations is important and that the Service can help accomplish this through enhanced disclosure in its financial and related statements.” (*GAO letter to Senators Akaka and Cochran, GAO-03-26R, Postal Financial Reporting, 11/13/02*)

Postal Service plans to enhance its financial disclosures

- The Postal Service said it plans to add “enhanced discussion of performance” to its periodic financial reports. Starting this fiscal year, the Postal Service will provide “explanations of material events or transactions and their projected impact on current operations and financial results,” said Postal Service Chief Financial Officer Richard Strasser in a comment letter included in the GAO's report. Strasser said the Postal Service will also provide “on quarterly basis, expectations for the upcoming quarter,” and “on a quarterly basis, explanation if actual results for the prior quarter differ significantly from previously discussed expectations.” Strasser noted, however, “We believe that our public disclosures to the PRC [Postal Rate Commission] far exceed on balance, the information that is legally required” of companies regulated by the Securities and Exchange Commission. (*Dow Jones Newswire, John Connor, 11/15/02*)

<p>Postal Service Inspector General clears former Postal Service top lobbyist of allegations that the lobbyist manipulated the Postal Service's federal budget to benefit the Democratic candidate for US Senate in Arkansas</p>

- The Postal Service's Inspector General Karla Corcoran exonerated the former top lobbyist of the Postal Service – Deborah Willhite - of trying to manipulate the Postal Service's federal budget to benefit the Democratic candidate for US Senate in Arkansas. (*FederalTimes.com, Dan Davidson, 11/11/02*) Willhite resigned October 21 amid allegations that she manipulated the federal mail budget to hurt the re-election chances of Senator Tim Hutchinson (R-AR) to benefit his opponent, Democrat Mark Pryor. Sources alleged

that Willhite, a native of Arkansas, pushed for budget cuts for Arkansas post offices and have Senator Hutchinson blamed. Willhite allegedly pushed to have money for a seasonal postal facility in Blytheville, AR transferred to Georgia post offices, allowing supporters there to credit Democratic Senator Max Cleland (D-GA), who was also in a close re-election. (*US News & World Report*, Paul Bedard, 11/4/02; *Associated Press*, 10/29/02, *Washington Times*, Audrey Hudson, 10/30/02; *Arkansas Democrat-Gazette*, Kevin Freking, 11/1/02) [See November 1, 2002 *GSE Report* for more information.]

- “We concluded that the senior vice president [Willhite] did not influence the decision to eliminate mail operations in Blytheville,” Corcoran wrote in a November 1 letter to Congressman John McHugh (R-NY). “All individuals interviewed stated that the Blytheville decision was based on financial considerations and the senior vice president did not influence the decision,” Corcoran said. Corcoran also noted that “funds were not allocated from Arkansas to Georgia postal facilities.” Corcoran wrote, “The elimination of postal operations at Blytheville did not have any effect on postal operations in Georgia.” (*Federal Times.com*, Dan Davidson, 11/11/02)

Postal Service and American Postal Workers Union (APWU) reach tentative two-year contract agreement

- The Postal Service and the APWU reached a tentative agreement on a two-year extension of their labor contract, which is due to expire November 20, 2003. The agreement, which still must be approved by a union advisory committee and rank-and-file members, would be the first of its kind in APWU history. The APWU represents 366,000 postal clerks and other post office employees. The agreement includes a 1.3% wage increase in 2003 and 2004 and four cost-of-living increases by late 2005. The agreement also includes a Postal Service pledge that it won't reassign employees whose jobs are eliminated to a position more than 50 miles from their current work location. The APWU also won a two-year extension of no-layoff protections for most full-time Postal Service workers. (*Wall Street Journal*, Rick Brooks, 11/12/02; *DM News*, Melissa Campanelli, 11/14/02)

Senate confirms Ruth Goldway and Tony Hammond to be Postal Rate Commissioners

- The Senate November 12 confirmed Ruth Goldway and Tony Hammond to be commissioners of the Postal Rate Commission. Goldway was appointed by President Clinton to serve a partial term in 1998. Her current term expires November 22, 2008. Hammond was appointed to complete a term expiring October 14, 2004. President Bush made a recess appointment of Hammond to be a commissioner August 6, 2002. The other commissioners are Chairman George Omas and Vice Chairman Danny Covington. No more than three members can be members of the same political party. There is one Democratic seat vacancy. (*DM News*, 11/18/02)

Goldway bio:

- Before being named to the PRC, Commissioner Goldway traveled with her husband, Professor Derek Shearer, to Finland where he served as U.S. Ambassador from 1994 through 1997. From 1991 to 1994, Goldway served as Manager of Public Affairs for the Getty Trust, the largest arts and education foundation in the U.S. Previously she served as Director of Public Affairs at California State University, LA. Goldway was Assistant to the Director of California's Department of Consumer Affairs during the 1970's and was elected council member and mayor of the city of Santa Monica from 1979 to 1983. She served as Founder and Chairperson of the Santa Monica Pier Restoration Corporation from 1983 - 1994. Goldway has lectured on the role of women in government, Finnish culture and society, urban planning, and consumerism at universities and professional associations throughout the U.S., Europe and in Japan. (*Postal Rate Commission website*, 11/18/02)

Hammond bio:

- Before being named to the PRC, Commissioner Hammond was owner and managing member of T. Hammond Company, a private consulting firm based in Arlington, VA. He also served as Senior Vice President of the direct marketing firm, Feather, Larson & Synhorst, and Senior Consultant to Forbes 2000, Inc. During the 1998 election cycle, Hammond was Director of Campaign Operations at the Republican National Committee where he was responsible for political programs nationwide. He was previously RNC Regional Field Representative in the Great Lakes Region and the Southern Region where he assisted campaigns and state party organizations in implementing RNC programs. From 1989 to 1994, Hammond was Executive Director, as well as Finance Director, of the Missouri Republican Party. Hammond served on Capitol Hill from 1979 to 1989 on the official staff of Congressman Gene Taylor (R-MO) as Legislative Director. During Taylor's tenure as Ranking Member of the Post Office and Civil Service Committee, Hammond dealt with the diverse issues and interests concerning U. S. Postal Service rates and operations. (*Postal Rate Commission website, 11/18/02*)

November 15, 2002

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